

May 23, 2012 (/full-blog/2012/05/contractual-relationships-between.html)

## Contractual Relationships Between Agricultural Growers and Commodity Buyers (/full- blog/2012/05/contractual-relationships-between.html)

"Audit Committee Investigation Findings" (/full-blog?category=%22Audit+Committee+Investigation+Findings%22), "Diamond Foods" (/full-blog?category=%22Diamond+Foods%22), "Gamble" (/full-blog?category=%22Gamble%22), "Pringles" (/full-blog?category=%22Pringles%22), "Procter" (/full-blog?category=%22Procter%22), "Walnut Purchase Agreements" (/full-blog?category=%22Walnut+Purchase+Agreements%22), "agricultural growers" (/full-blog?category=%22agricultural+growers%22), "commodity buyers" (/full-blog?category=%22commodity+buyers%22), "walnut growers" (/full-blog?category=%22walnut+growers%22)



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By: Robert Proudfoot, Staff Member

On February 8, 2012, Diamond Foods released the results of its Audit Committee Investigation Findings regarding the accounting of crop payments to walnut growers and it found: 1) the payments were accounted for in the wrong fiscal accounting periods by \$20 million in 2010 and \$60 million in 2011, and 2) internal control over financial reporting had material weaknesses.[1] ([http://#\\_edn1](#)) As a result of the internal audit findings, CEO Michael J. Mendes and CFO Steven M. Neil were placed on administrative leave[2] ([http://www.blogger.com/#\\_edn2](#)), Procter & Gamble called off its \$2.35 billion sale of Pringles[3] ([http://www.blogger.com/#\\_edn3](#)) to Diamond Foods, and Diamond shares are trading around \$24 a share, off from September 2011 highs of \$90. So, what went wrong? In nutshell, Diamond Foods and their walnut growers had a vague contract that did not 1) have a proper escalation clause of higher market prices, 2) explicitly state when payments would be made and how they would be accounted for, and 3) adequately prepare both parties for being adverse parties with adverse interests after being a collective cooperative for almost 100 years.

Diamond Foods was founded in 1912 as a walnut cooperative to market and sell walnuts collectively and voted to convert to a for-profit company and go public in 2005.[4] ([http://www.blogger.com/#\\_edn4](#)) While many growers opted to partake in the IPO by signing long-term contracts to sell exclusively to Diamond Foods[5] ([http://www.blogger.com/#\\_edn5](#)), some immediately started voicing concerns about inherent adverse interests presented between a for-profit company and its commodity suppliers (i.e. the company wants the lowest price possible to increase earnings whereas the growers desire the highest price for their crop).[6] ([http://www.blogger.com/#\\_edn6](#)) While growers did receive stock in the newly converted for-profit company with potential for capital gain and dividend income, this did not completely offset the adversity of the parties.[7] ([http://www.blogger.com/#\\_edn7](#)) The long-term walnut agreement signed by growers as a condition for receiving shares[8] ([http://www.blogger.com/#\\_edn8](#)) in Diamond Foods was summarized in its 2011 Annual Report:

[Diamond Foods] have entered into long-term Walnut Purchase Agreements with growers, under which they deliver their entire walnut crop to us during the Fall harvest season and we determine the minimum price for this inventory by March 31, or later, of the following calendar year. The final price is determined no later than the end of the Company's fiscal year. This purchase price will be a price determined by us in good faith, taking into account market conditions, crop size, quality, and nut varieties, among other relevant factors. Since the ultimate price to be paid will be determined subsequent to receiving the walnut crop, we must make an estimate of price for interim financial statements. Those estimates may subsequently change and the effect of the change could be significant.[9] ([http://www.blogger.com/#\\_edn9](#))

Under this contract, Diamond Foods received the walnut crop in the fall, made its first payment in March the following year and a final make-up payment, as determined by Diamond Foods, almost a full year after the growers tendered their goods. Frustrated from their unequal bargaining power and years of payments below market price, the growers unsuccessfully attempted to form a class action to sue for breach of contract, claiming the contract was one of adhesion and unconscionable.[10] ([http://www.blogger.com/#\\_edn10](#)) California state law requires that all nut sales be in writing and state the full purchase price.[11] ([http://www.blogger.com/#\\_edn11](#)) unless both parties agree to waive this requirement, as were the case with walnut growers having long-term grower contracts with Diamond Foods.[12] ([http://www.blogger.com/#\\_edn12](#)) This ambiguity in contract price led to grower discontent when walnut prices skyrocketed from increased demand.[13] ([http://www.blogger.com/#\\_edn13](#)) The ambiguity also allowed Diamond Foods to temporarily exploit the uncertainty of payment terms to manipulate the payments' accounting by pushing their reporting to next fiscal year to improve annual earnings.[14] ([http://www.blogger.com/#\\_edn14](#))

The recent implosion of Diamond Foods once again demonstrates the importance of strong, clear contracts between agricultural growers and commodity buyers—especially for converted cooperatives that are now publicly traded for-profit companies.

[1] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) *Diamond Foods Announces Audit Committee Investigation Findings*, DIAMOND FOODS (Feb. 8, 2012), <http://phx.corporate-ir.net/phoenix.zhtml?c=189398&p=RssLanding&cat=news&id=1658627>.

[2] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Diamond Foods, *supra* note 1.

[3] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) *Diamond Foods Issues Statement Regarding Termination of Pringles Transaction*, DIAMOND FOODS (Feb. 15, 2012), <http://phx.corporate-ir.net/phoenix.zhtml?c=189398&p=RssLanding&cat=news&id=1661222>.

[4] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Shermain D. Hardesty, *The Conversion of Diamond Walnut Growers*, 23 JOURNAL OF COOPERATIVES 40, 40-41 (2009), *available at* <http://purl.umn.edu/56901>.

[5] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Shermain D. Hardesty, *The Bottom Line on the Conversion of Diamond Walnut Growers*, 8 AGRIC. AND RES. ECON. UPDATE (Univ. of Cal. Giannini Foundation), no. 4, at 1, 11 (2005) *available at* [http://sfp.ucdavis.edu/cooperatives/reports/giannini\\_diamond.pdf](http://sfp.ucdavis.edu/cooperatives/reports/giannini_diamond.pdf).

[6] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Holman W. Jenkins, *Accounting for Nuts: Blame a misalignment of incentives for the scandal at Diamond Foods*, WALL STREET JOURNAL (Feb. 10, 2012), <http://online.wsj.com/article/SB10001424052970203824904577214853918682554.html>.

[7] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Hardesty, *supra* note 4, at 50-51.

[8] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Hardesty, *supra* note 4, at 44.

[9] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) *Diamond Foods 2010 Annual Report*, DIAMOND FOODS, at 18 (Sept. 15, 2011), <http://www.sec.gov/Archives/edgar/data/1320947/000119312511249300/d232533d10k.htm>.

[10] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) *Walnut Producers of California v. Diamond Foods, Inc.*, 114 Cal.Rptr.3d 449, 454 (Cal. Ct. App. 2010).

[11] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Cal. Agric. Code § 62801 (West 1983)

[12] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) *Walnut Producers of California*, 114 Cal. Rptr.3d at 462-63.


[13] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) John Jannarone, *Hidden Flaw in P&G's Diamond Deal*, Wall Street Journal (Sept. 27, 2011), <http://online.wsj.com/article/SB10001424052970204831304576595000985103090.html>.

[14] ([http://www.blogger.com/#\\_ednref](http://www.blogger.com/#_ednref)) Jenkins, *supra* note 6.

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This post was written in February 2012. Please see the press release about Oaktree Capital Management's \$225 million investment in Diamond Foods(released on May 23, 2012):<http://investor.diamondfoods.com/phoenix.zhtml?c=189398&p=RssLanding&cat=news&id=1699044>

Also, Diamond Foods has implemented a new Walnut purchase agreement with shorter

contract periods, clearer pricing mechanisms, and accelerated payment times. See the new form here:  
<http://www.sec.gov/Archives/edgar/data/1320947/000119312512244357/d356490dex991.htm>

A brief explanation of the new walnut contract and funding can be found in a Diamond Foods Presentation (PDF): <http://investor.diamondfoods.com/phoenix.zhtml?c=189398&p=irol-presentations>

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